United States Court of Appeals

for the Second Circuit

REPLY BRIEF

76-4067

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 76-4067

Arthur Lipper Corporation and
Arthur Lipper III,

Petitioners,

v.

Securities and Exchange Commission,

Respondent.

Petition for Review of Orders of
Securities and Exchange Commission

REPLY BRIEF OF PETITIONERS

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ARGUMENT

I. THE SEC'S ATTEMPT TO MEET ITS BURDEN OF PROOF BY SUBSTITUTING ASPERSIONS AND INNUENDOES FOR EVIDENCE, UNDERLINES ITS FAILURE TO SUBSTANTIATE ITS CHARGES AGAINST PETITIONERS; IT MAY NOT IGNORE THE APPLICABILITY OF THE NEW YORK LAW BURDEN OF PROVING THE FRAUD IT HAS CHARGED.

A. THE SEC'S SUGGESTIONS THAT IOS "WAS AN INTERNATIONAL SWINDLE" AND THAT PETITIONERS WERE PARTICIPANTS IN THE SWINDLE ARE ILLUSTRATIVE OF ITS ATTEMPT TO ESTABLISH GUILT BY ASSOCIATION AND JOURNALISTIC SENSATIONALISM RATHER THAN BY EVIDENCE.

Symptomatic of its attempt to meet its burden of proof by innuendo rather than by evidence, the SEC at the very beginning of its brief chooses the curious "authority" of a book written about IOS by profit-seeking British newspapermen who wrote that IOS "was an international swindle." 1/ Copying

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1/ SEC Br. p. 2, quoting from C. Raw, B. Page & G. Hodgson, Do You Sincerely Want To Be Rich? 4 (1971). Pages in the brief of the Securities and Exchange Commission will be referred to as "SEC Br. p.___"; references to the pages of the Joint Appendix are "A___" and to the record are "Doc___R___".

the journalistic license, the SEC would have the Court believe that this "case is a further chapter"[2] in the history of IOS evidently hoping to encourage the Court not to waste too much time on the evidence because Arthur Lipper III, the individual petitioner herein, is just another "IOS-connected person."[3] The Court, however, will find from less inflammatory sources, namely the record cited herein and in Petitioners' opening brief, ample proof that the record not only fails to sustain the SEC's charges but also convincingly establishes Petitioners' good faith.

To say that IOS "was an international swindle" is a sweeping generalization on which the record in this case contains not one shred of evidence. Even the media book which the SEC holds out as authority stated, "...of course IOS did a great deal of business which was perfectly honest in itself, and continues to do so. We have talked to many of the people who work for IOS, and there were a lot of decent, even idealistic, people among them."[4] As noted by another author, at one time

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2/ Ibid.

3/ Ibid.

4/ Ibid. Although the SEC flatly states that it "...expelled IOS and its affiliates from the United States securities markets in consequence of their violations of the federal securities laws..." (SEC Br. p. 2), including "unlawful" sales of the shares of the foreign investment companies (SEC Br. p. 9), there were no findings of illegality in the IOS Settlement Order (A 368, 369).

or another associated with IOS were ..."the sons of Franklin D. Roosevelt, King Gustav VI of Sweden, and David Ben-Gurion of Israel; along with Pat Brown, the former governor of California; Wilson Wyatt, the former lieutenant-governor of Kentucky; Erich Mende, the former vice-chancellor of Germany; Eric Scott, the former president of the Toronto Stock Exchange; Sir Eric Wyndham White, the former head of the UN's General Agreement on Tariffs and Trade...and a representative sampling of lesser mandarins, princes, and pundits in every country where IOS does business."5/

In fact, the ultimate corporate fate of IOS and its activities subsequent to the period 1967-1968, when the transactions at issue in this case occurred, has not been and could not have been made a part of this record. We would hope that this Court would judge persons who perform services for controversial clients by their own deeds uncolored by irrelevant activities of the clients. However, it seems clear that the SEC's litigating history in pursuing IOS (rightly or wrongly), with its attending bitterness, cannot be surpressed; the SEC's antagonism in its brief surfaces

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5/ Bert Cantor, The Bernie Cornfeld Story, 9-10 (1970). Petitioners recognize that this book is no more authoritative or a credible source of evidence than the book used by the SEC, *supra* n. 1. However, in view of the impression which the SEC seeks to create that anyone who dealt with or was associated with IOS was a knowing participant in a gigantic swindle, Petitioners believed it appropriate to mention the names of other dramatis personae.

in its use of damning generalizations, aspersions and innuendos.[6/]

B. THE SEC'S ASSERTIONS THAT ARTHUR LIPPER CORPORATION WAS FORMED AT THE BEHEST AND WITH THE FINANCING OF IOS FOR THE EXPRESS PURPOSE OF FUNNELING COMMISSIONS TO IOS IN ACCORDANCE WITH A PREARRANGED SCHEME BETWEEN COWETT AND LIPPER ARE UNSUPPORTED BY, AND DIRECTLY CONTRARY TO, THE EVIDENCE IN THIS RECORD.

The SEC claims, without citing any evidence, that "...Lipper, at IOS's inducement, and with the aid of a subsequent financial guarantee...formed Lipper Corp."[7/] Equally barren of supporting evidence is its claim that "Lipper Corp. was formed for the specific purpose of funnelling commissions paid by to (sic) IOS-affiliated funds back to IOS."[8/] The facts are, as the record shows, that after Mr. Lipper's partners at Zuckerman, Smith & Co. declined to establish overseas branch offices at the suggestion of IOS, Mr. Lipper formed Arthur Lipper Corporation

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6/ Contrary to the impression sought to be created by the SEC, IOS officers and directors took seriously their fiduciary obligations to the foreign investment companies. Swiss Credit Bank, a pillar of Western European financial respectability, in accordance with a practice uniformly followed by Swiss banks, at one time was charging IIT an additional one-half of the normal NYSE commission on transactions effected on the NYSE. Mr. Cowett headed a group that demanded that Swiss Credit cease making additional charges. Swiss Credit replied by offering a 50% rebate to IOS, which was refused. Finally, after three months of argument, Swiss Credit agreed not to make any additional charges and followed that policy with respect to all of the foreign investment companies. (A 128-130) This concrete example of Mr. Cowett's good faith must overcome the SEC's broad characterizations that are unsupported by specific proof.

7/ SEC Br. pp. 2-3, also see pp. 4, 5 and 12.

8/ SEC Br. p. 51, also see p. 4.

with his own money for the purpose of effecting transactions for financial institutions, including the foreign investment companies, who would not be able to contact U.S. broker-dealers directly under the IOS Settlement Order, and for no other purpose.[9]

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[9] During the course of negotiations leading to the IOS Settlement Order, IOS became aware that in the future it would be required to place orders for securities traded in the United States securities markets with foreign brokerage firms or with United States brokerage firms having a foreign branch office. Under the terms of the order IOS was precluded from dealing directly with brokers in the United States. (A 40-41; A 368-377; Doc. 1, R 838-839)

Mr. Lipper resigned his partnership in Zuckerman, Smith and organized Arthur Lipper Corporation because the partners at Zuckerman, Smith declined the suggestion of IOS to establish overseas branch offices to service the brokerage business of the foreign investment companies. Zuckerman, Smith had no experience in managing foreign branches and its governing partners preferred to remain essentially a retail-oriented and specialist firm on the NYSE. (A 153-154)

Among other expenditures in establishing Arthur Lipper Corporation, Mr. Lipper purchased a seat on the NYSE for $305,000 and opened offices in London and Geneva. No individual or company associated with IOS had any financial interest in Arthur Lipper Corporation when it was formed; nor has any such individual or company ever acquired any equity or profit interest in Arthur Lipper Corporation. The stockholders of Arthur Lipper Corporation at the time these proceedings began were Mr. Lipper, his wife, and certain persons serving as officers, directors or full time employees of Arthur Lipper Corporation (A 157-158)

On November 1, 1967, seven months after Arthur Lipper Corporation was formed, Arthur Lipper Corporation began to clear its own transactions (A 195, 232). During this same period the securities industry had a paper backlog and Arthur Lipper Corporation was often unable to make timely delivery to its customers of securities purchased, nor were Arthur Lipper Corporation's customers able to make timely delivery of securities sold because of delinquent transfers from other brokers. (A 232) As a consequence, Arthur Lipper Corporation needed additional capital as a margin of safety to avoid encountering a net capital problem under the rules of the NYSE. (A 124, 232-233)

The SEC also asserts that "...during early 1967, Lipper and Cowett conceived a scheme designed to solve both of the

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9/ cont'd

Ultimately, an arrangement was worked out in early 1968 whereby Mr. Lipper's brother, Michael Lipper, who was an officer of Arthur Lipper Corporation, loaned Arthur Lipper Corporation $500,000 on a subordinated basis. (A 196-198, 233) Mr. Lipper arranged to have Guinness Mahon, & Company, a merchant banker located in England, loan Michael Lipper the $500,000. In accordance with NYSE rules, Guinness, Mahon waived any lien against Arthur Lipper Corporation and restricted its recourse to Michael Lipper. IOS guaranteed Michael Lipper's credit to Guinness, Mahon. (A 195-198) The amount of the loan was subsequently raised to $1 million and repaid in November 1969 (A 198)

Arthur Lipper Corporation did not need the additional money for working capital or for investment in any operations of the firm. Mr. Lipper could have obtained a personal loan for the purpose of relending the proceeds to Arthur Lipper Corporation, but his tax advisers informed him that, upon repayment of the loan, Mr. Lipper would have received a dividend taxable as ordinary income. Since Arthur Lipper Corporation did not take investment positions and did not engage in underwritings or commodities transactions, the loan was practically riskless from the lender's standpoint. (A 195-196) IOS was willing to guarantee the loan because it was important to IOS to maintain its crucial communications link with the U.S. securities markets. (A 124)

IOS certainly had an interest in the maintenance of Arthur Lipper Corporation's operations, as it would have had in any broker which was serving as IOS's link to the U.S. securities markets. Through the communications network and the trading department established by Arthur Lipper Corporation, IOS was able to obtain fast and efficient execution of its orders to buy and sell in the U.S. securities markets. Thus, in the creation of Arthur Lipper Corporation there was a mutuality of interests: Mr. Lipper was able to establish a profitable brokerage business and IOS was able to service the foreign investment companies efficiently.

problems facing IOS."[10] According to the SEC, the problems were "...improving the profit potential of IPC's operations... and devising a method by which...[the foreign investment companies] could continue to execute portfolio transactions in the American securities markets notwithstanding the terms of the Commission's settlement order."[11] The record however neither establishes that Mr. Lipper participated in any such prearranged scheme nor that the Petitioners violated the IOS settlement order in any way (no violation by anyone was ever alleged).[12]

10/ SEC Br. p. 11.

11/ Ibid; also see pp. 13, 18 and 24.

12/ Throughout its brief, the SEC, by aspersions, innuendoes, misstatements and other deceptive wording, tries to create the impression that Petitioners were knowing participants in wrongful conduct whose claims of good faith should be ignored. For example, at page 3, footnote 8 of its brief, the SEC implies that Arthur Lipper Corporation was a knowing participant in the sale by IOS and its affiliates of unregistered securities over a long period of time resulting in the entry of a permanent injunction against the IOS defendants. In fact the Court did not make any findings that Arthur Lipper Corporation knew that it was participating in the sale of unregistered securities (in fact Arthur Lipper Corporation inquired and was told by IOS that the securities were registered); Arthur Lipper Corporation sold these securities on behalf of two IOS related investment companies on three trading days in April, 1969, the majority on the American Stock Exchange. When the action against Arthur Lipper Corporation was dismissed with prejudice in 1973, more than four years after it was commenced, the Court concluded (paragraph 21): "Under all the circumstances reflected in these findings of fact and conclusions of law, this Court will not enter a permanent injunction against Lipper Corp. in this action." Securities Exchange Commission v. IOS, Ltd. (S.A.), 69 Civ. 3594 (S.D.N.Y.)

The relationship between Petitioners and IOS was created within the framework of the existing practices in the securities industry.[13/] Arthur Lipper Corporation was not guaranteed business by IOS on the condition that it give-up on NYSE and over-the-counter transactions. The record shows that at that time give-up arrangements were so embedded in the normal practice of the securities industry, Mr. Lipper and Mr. Cowett did not even discuss the matter when Arthur Lipper Corporation was being formed. It was simply assumed by Mr. Lipper that his firm, like the 12 other NYSE member firms described in the record, would follow its customers' directions and give-up on all transactions--both those on the exchanges and those in the over-the-counter market.[14/]

Naturally the working relationships between IOS and Arthur Lipper Corporation were close. It in no sense reflects questionable integrity for a broker receiving a substantial segment of its business from customers which are part of one financial-conglomerate to seek to continue the relationship by performing as many related

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13/ The overriding policy of the foreign investment companies with respect to portfolio transactions was to obtain the best execution (A 115; Doc. 1,R 441, 543) The willingness of a broker to give-up was not made a condition for executing any of the specific transactions described in the record or any other transactions. (Doc. 1, R 366, 368, 406) Brokerage activity of the foreign investment companies varied only with the normal investment considerations prompting transactions. (Doc. 1, R 444-445)

14/ A. 211 Another related misstatement by the SEC is its claim that "Cowett and Lipper selected as the rate which Lipper Corp. would charge IOS affiliates for their over-the-counter business the [NYSE] minimum commission rate..." (SEC Br. p. 14; also see pp. 37-38)As indicated above, there were no such discussions on the subject by Cowett and Lipper. Mr. Lipper simply followed industry practice on the advice of his counsel. See II and III <u>infra.</u>

customary services as possible.[15] While the business arrangement between IOS and Arthur Lipper Corporation was unique in the sense that Arthur Lipper Corporation became IOS's communication link to the U.S. securities markets, it is not unusual to find a close working relationship between large institutional customers seeking fast and efficient execution of orders and brokers seeking to furnish such executions and related administrative services to the customers' satisfaction. The record does not justify an inference that, because of this close relationship, Mr. Lipper and Arthur Lipper Corporation would knowingly engage in wrongdoing at the request of IOS.[16]

Other significant missstatements of the record by the SEC are found at page 15 of its brief. Here it states that "petitioners and their affiliates never met with Exchange personnel to ascertain whether Lipper Corp. might permissibly charge less than the Exchange's commission rate for executing portfolio transactions

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15/ In this regard the fact that Mr. Lipper was a director of two IOS related mutual funds and the president of one of the funds for a short period of time in 1966 (A 37-39, 192-193) and the fact that Arthur Lipper Corporation performed miscellaneous services for the foreign investment companies, does not establish as the SEC claims, that "...both Lipper personally, and Lipper Corp. were enmeshed in various facets of the IOS operations...." (SEC Br. p. 17, n 22)

16/ The objective of IOS in seeking to convert IPC's operations from a loss position to a profit position is understandable: IOS was an 80% owner of IPC and thus a direct beneficiary of such a change. IOS would presumably have had this objective whether or not it had been required to divest itself of IPC. And any purchaser of IPC could readily tell that reciprocal business, which was a large part of its income in 1967 and 1968, would no longer be a significant source of IPC's income after the sale. The fact that IOS had the objective to turn IPC into a profitable enterprise is not evidence of a bad purpose or fraudulent practice.

in the over-the-counter market. Nor were petitioners ever told by anyone at the Exchange that Lipper Corp. could not...[charge less] than the Exchange's minimum commission rate." (citations omitted) While literally true, these statements are substantively false. The record shows that Mr. Lipper was relying on his own experience and on Mr. Conwill's advice to comply with NYSE requirements, and Mr. Conwill did have discussions with NYSE officials with regard to the proper charge to be made on over-the-counter transactions--the minimum NYSE rate.[17/]

C. THE SEC MAY NOT IGNORE THE NEW YORK LAW WITH RESPECT TO THE BURDEN OF PROOF: GOOD FAITH, INNOCENCE AND HONESTY ARE PRESUMED UNLESS THE PERSON ALLEGING FRAUD PROVES IT.

The SEC misconstrues the section of Petitioners' original brief contending that the law of New York should be applied with respect to the burden of proof.[18/] While it is relatively clear that one who alleges fraud, as a matter of procedure, has the burden of proving his case under the applicable substantive law, the SEC instead chooses to attack a strawman of its own making. At page 43, note 1 of its brief, the SEC said: "The argument that state law standards govern Commission administrative proceedings was rejected as far back as 1949: [citing <u>Norris & Hirshberg</u> v. <u>Securities and Exchange Commission</u>, 177 F. 2d 228 (D.C. Cir. 1949)]...." Petitioners agree with the holding

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17/ A 274; also see II and III <u>infra</u>.

18/ Petitioners' Opening Brief, pages 40-42.

of that case--that state substantive law does not apply to the federal securities laws; the case, however, does not hold that state law is inapplicable with respect to the procedural burden of proof.[19]

The leading case cited by Petitioners, Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962), aff'd 319 F.2d 634 (7th Cir. 1963), does indeed support Petitioners' position.[20] Kohler was an action to recover damages for sale of stock in claimed violation of Section 10(b) and Rule 10b-5. The federal court applied the law of Wisconsin with respect to the burden of proof, stating:

> Fraud is never presumed nor can it be established by inference. Mescall v. W.T. Grant Co., 133 F. 2d 209, 211 (7th Cir. 1943). In Estate of Hatten, 233 Wis. 199 at page 208, 288 N.W. 278, at page 282 (1940), the court stated:
>
> > "***In civil actions, where fraud, crime, criminal conduct or conspiracy is alleged, the burden rests upon him who so charges, to establish the proof of such allegations by clear and satisfactory evidence,***" (Citations omitted.)
>
> In the instant case plaintiff has not established a cause of action for fraud by a preponderance of the evidence. His proof falls far short of establishing fraud by clear and satisfactory evidence.

19/ Norris & Hirschberg involved a broker-dealer having the complete confidence of its customers which personally sold to and bought unlisted stocks from its customers, without disclosing the true capacity in which it was acting with considerable profit, in violation of the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

20/ 208 F. Supp. 827.

The rule that state law applies with respect to the procedural burden of proof is consistent with fundamental due process. Surely an accused cannot be placed in the position of proving his innocence because of agency fiat. What is important is the fundamental principle that one who charges fraud should be required to prove it. Governmental agency claims have no special sanctity in this regard.

II. GIVE-UP PRACTICES AND COMMISSION RATES APPLIED BY NYSE MEMBERS TO OVER-THE-COUNTER TRANSACTIONS ARE THE HEART OF THIS CASE AND ARE NOT "IRRELEVANT" AS THE SEC CLAIMS.

The SEC ignored evidence in the record with respect to the universal practice of NYSE members to apply minimum NYSE commission rates to over-the-counter agency transactions, stating that there was no NYSE requirement that NYSE members charge minimum NYSE commission rates.[21] The SEC similarly dismissed as irrelevant give-up practices by NYSE members on over-the-counter agency transactions.[22] In so doing the SEC preferred to ignore the evidence in the record with respect to the *de facto* jurisdiction exercised by the NYSE in the over-the-counter market. Ironically, the very factor that caused the SEC to summarily dismiss Petitioners' arguments in this regard, the antitrust laws, explains why the NYSE's positions were always fudged; but the NYSE statements lie in this record like pieces in a puzzle. The SEC said:

21/ SEC Br. pp. 14, 35-37; also see A 438.

22/ SEC Br. pp. 31-42.

> Respondents appear to suggest that the practice of charging the stock exchange commission on over-the-counter transactions was not merely a practice, resorted to for convenience where appropriate, but rather reflected some type of agreement or conspiracy among broker-dealers to charge that rate under all circumstances. We can hardly assume the existence of such an agreement, particularly in view of the fact that, if practiced in the over-the-counter market where no statute affords the slightest justification for rate fixing, it would have been a flagrant violation of the antitrust laws. 23/

All the pieces of the puzzle were in the record if the SEC only took the time to put them together. In a letter dated July 21, 1967, to NYSE members concerning a new commission schedule, shortly after Arthur Lipper Corporation became a NYSE member, the then NYSE President made some revealing comments about the NYSE's views with respect to the proper rate to be applied by NYSE members on agency over-the-counter transactions:

> Another complication which needs further study is that not only NYSE trades may be affected by a new schedule. Member firms have <u>traditionally</u> used the NYSE schedule to establish commissions on agency over-the-counter trades, and other Exchanges have followed similar schedules. An order based NYSE schedule should take into consideration the economic effect of possible use of the same structure in such other trades. (Emphasis added) 24/

When the above language is read in conjunction with Mr. Conwill's testimony about what he was told by Mr. Bishop, then head of the NYSE Department of Member Firms, all the pieces of the puzzle fit neatly together:

23/ A 438, note 40

24/ A 340

> He told me, by saying that if we charged anything other than the minimum rate, we would have to justify it, because from his point of view, and I do remember this conversation, if you had--if you were required to make a given charge on executing a New York Stock Exchange listed security, it was presumably just as difficult to make an execution in the over-the-counter market, and therefore, the same charge was appropriate. 25/

In short, on over-the-counter agency transactions, the NYSE in effect required its members to charge minimum NYSE commission rates. Whether this requirement was a result of a conspiracy or not is beyond the scope of this record. What is clear, however, is that the so-called "cost test" was just a facade which the NYSE used to get around the antitrust laws. 26/

25/ A 274. The importance of the minimum commission structure to the NYSE is underscored by a letter dated November 22, 1968 from the then NYSE President to NYSE members (attaching a letter to the then SEC Chairman) in which the NYSE reserved the right to change its rules or interpretations if it became apparent that reciprocal arrangements among brokers were circumventing the anti-rebate provisions of the NYSE Constitution. (A 344-347)

26/ In addition to the documentary evidence discussed in Petitioners' Opening Brief at pages 19 through 22, see also the interpretations of the NYSE issued at the time give-ups were banned. (A 459, 461) Interpretation #13 provides:

> (13) A member organization may not give up any part of commissions on over-the-counter securities transactions to a nonmember in consideration of receiving listed commission business.

This interpretation was necessary only if over-the-counter give-ups had been permitted prior to December 5, 1968.

III. PETITIONERS ACTED REASONABLY AND IN GOOD FAITH IN FOLLOWING THEIR COUNSEL'S ADVICE TO ADHERE TO INDUSTRY PRACTICE.

A. THE SEC'S CLAIMS, THAT COUNSEL'S ADVICE WAS NOT DISINTERESTED AND COMPETENT, ARE UNFOUNDED.

The SEC attempts to impeach Petitioners' counsel, Allan F. Conwill, a partner in the firm of Willkie Farr & Gallagher, by claiming that Mr. Conwill was not disinterested and that his advice was incompetent because he arrogantly ignored the SEC's views.[27/] The record shows, however, that Mr. Conwill considered very carefully the views of the SEC and the SEC staff in advising the Petitioners in a professional manner.

Mr. Conwill, who had been associated with Willkie Farr & Gallagher since 1949, becoming a partner in 1956, had been General Counsel of the SEC and Director of its Division of Corporate Regulation, having primary responsibility over investment companies, from June 15, 1961 through June 30, 1964. (A 236) As a former high SEC staff official Mr. Conwill knew well the distinction between the views of the SEC and those of its staff.[28/]

27/ SEC Br. pp. 16, 45-47.

28/ See, e.g., A 288-290

Although the SEC seeks to blur this distinction,[29] Mr. Conwill had it in mind in formulating the advice he gave to Mr. Lipper that "the SEC staff was wrong, as a matter of law."[30]

The distinction which Mr. Conwill drew between the SEC and its staff is well recognized in the law. Opinions expressed by staff officers of an administrative agency are not administrative rulings by the agency itself and need not be followed by the courts. See Spirt v. Bechtel, 232 F.2d 241, 244 (2nd Cir. 1956), involving an opinion of the general counsel of U.S. Maritime Commission. With respect to an opinion of a general counsel of the SEC, the Court in Colby v. Klune, 178 F. 2d 872, 875, note 15 (2nd Cir. 1949) had this to say:

> As this "opinion" of the General Counsel is not part of the "Commission's formal action," it does not bind the Commission, and certainly not the courts. Since we disagree with it, we disregard it.

29/ In its brief the SEC inaccurately states that Mr. Conwill admitted advising Mr. Lipper "of the Commission's position--that give-up payments on over-the-counter business was unlawful..." (SEC Br. p. 16) The record shows that Mr. Conwill told Mr. Lipper of the SEC staff's opinion. Mr. Conwill's testimony is as follows (A 290):

> HEARING EXAMINER BLAIR: Just to make it clear, since the use of the SEC frequently is used interchangeably in reference to the Staff and to the members of the Commission, were you advising Mr. Lipper with respect to the Commission as a Commission view, or Staff view?
>
> THE WITNESS: I was advising him as to the Staff view. Without necessarily ruling out what a Commissioner's view might be.

The SEC also inaccurately used the word "Commission" instead of "SEC staff" in the first line of page 46 of its brief, and the word "agency" instead of "SEC staff" in the first line of note 2 on the same page.

30/ Mr. Conwill made it perfectly clear that he advised Mr. Lipper of the view of the SEC staff: "I was advising him as to the Staff view." (A 290)

Mr. Conwill gave Petitioners competent advice, constantly taking into consideration the views of the various regulatory authorities as those views evolved.

During the early part of 1967, when Mr. Conwill was advising Mr. Lipper and Arthur Lipper Corporation in connection with the organization of the firm, Mr. Conwill had a number of discussions with representatives of the NYSE, including Mr. Robert Bishop, Vice President in charge of the Department of Member Firms. The purpose of these conversations with the personnel of the NYSE was to make certain that the new proposed member (i.e., Arthur Lipper Corporation) was starting out properly in accordance with all NYSE regulations. Based upon these conversations, Mr. Conwill gained the impression that any charge less than the minimum NYSE standard commission rate would create problems with the NYSE. The basis for Mr. Conwill's impression was a conversation with Mr. Bishop in which Mr. Bishop told Mr. Conwill that the minimum NYSE standard commission was the customary rate charged by member firms in the over-the-counter market, since presumably it costs as much to execute an over-the-counter transaction as it does to execute a transaction on the NYSE. (A 238-242, 274)

In the early part of 1967 Mr. Conwill was asked by Arthur Lipper Corporation whether it was lawful and/or appropriate for Arthur Lipper Corporation to follow customer directed give-up instructions with respect to over-the-counter transactions,

both generally and with respect to the foreign investment companies. Mr. Conwill advised Mr. Lipper that over-the-counter give-ups were generally, and with respect to the foreign investment companies, entirely lawful. Based upon personal research Mr. Conwill was aware of no adjudicated case that was inconsistent with his advice to Mr. Lipper, (A 243-244), and in fact there was none.

At the time Mr. Conwill gave his advice to Mr. Lipper, Mr. Conwill was aware of no prohibitive rules of any stock exchange inconsistent with his advice. Mr. Conwill knew that give-up practices were acknowledged, recognized, and tolerated by all of the U.S. stock exchanges, including the NYSE. At the time he gave the advice to Mr. Lipper, Mr. Conwill was aware that Rule 25 of the NASD Rules of Fair Practice provided generally that a member of the NASD is not permitted to deal with a non-member broker-dealer on any terms different from the terms on which he deals with the public. The effect of this rule is to authorize the sharing of commissions among members of the NASD. (A 243-245)

When Mr. Conwill gave this advice to Mr. Lipper there were no rules of the SEC which prohibited give-ups in the over-the-counter market nor was there any SEC case which had decided that

over-the-counter give-ups were per se unlawful. Mr. Conwill was aware of the Special Study of Securities Markets which was published in 1963 in which the SEC was critical of give-ups and of a letter in 1966 from Irving Pollack, Director of the Division of Trading and Markets, addressed to each of the national stock exchanges and the NASD, in which Mr. Pollack stated that give-ups from over-the-counter transactions had long been recognized as illegal and improper. Mr. Conwill was also familiar with the SEC's Mutual Fund Study published in 1966, in which it was stated (without citation of an administrative rule or administrative or judicial case authority) that give-ups from over-the-counter transactions to a broker who exercised no necessary function in connection with the transaction were long recognized as improper and unlawful.[31] Mr. Conwill considered these statements as

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31/ Since IOS was an 80% owner of IPC, realistically a give-up to IPC was a give-up to IOS which IOS naturally encouraged. IOS bore a portion of the costs of the communications system and all of the charges of London & Dominion Trust Company and the personnel who determined whether to accept or reject an investment adviser's suggestion. Consequently, IOS clearly performed <u>necessary functions</u> in connection with the over-the-counter transactions, give-ups from which are challenged in this action. Were it not for the necessary functions IOS so performed, the over-the-counter transactions of the foreign investment companies could not have been effected because these companies could not contact market makers or any other broker-dealers in the United States directly because of the IOS Settlement Order.

pronouncements, as distinguished from adjudicated holdings.[32/] He regarded Mr. Pollack's letter more in the nature of an advocate urging corrective action by the exchanges. Therefore Mr. Conwill did not consider such statements to be entitled to the weight of law. (A 249)

Mr. Conwill did not specifically ask representatives of the NYSE whether over-the-counter give-ups were appropriate, but from his conversations in early 1967 with such representatives, it was Mr. Conwill's understanding that the practice was tolerated by the NYSE and customary in the industry. (A 250-251)[33/]

Mr. Conwill was aware that under the IOS Settlement Order IOS was not to conduct any activity subject to the jurisdiction of the SEC. Consequently, if the foreign investment companies or any of the fund managers were to order the purchase or sale of securities in the U.S., the Settlement Order would have been violated. As a result an arrangement was established, with the full knowledge and acquiescence of the SEC staff, whereby IOS

32/ These pronouncements did not specify that over-the-counter give-up arrangements violated any particular provision of the Federal securities laws, were remarkably absent of supporting citations for "long-standing" positions and, finally, were completely divorced of factual context. In short, neither the SEC nor its staff were confronted, as were Arthur Lipper Corporation, a member of the NYSE, and Mr. Conwill, its counsel, with deciding whether to adhere to standard industry practice and follow give-up instructions of its customers or to participate in a rebative practice which would have been most certainly challenged by the NYSE.

33/ See opinion letters of another law firm confirming Mr. Conwill's understanding, specifically a conversation with a NYSE official who advised "...that there is no restriction...." (A 335, 336)

would place orders for the purchase or sale of securities with either a foreign office of a U.S. broker-dealer outside the U.S. or with a foreign broker-dealer and that broker-dealer would cause the order to be transmitted for execution by a firm in the United States. Mr. Conwill was aware of the arrangement ultimately worked out with Arthur Lipper Corporation. (A 252-253)

In early 1968, Mr. Conwill advised Arthur Lipper Corporation to cease all over-the-counter sharing of commissions on behalf or at the direction of U.S. registered investment companies and, in fact, to make no charge at all when Arthur Lipper Corporation executed over-the-counter transactions for U.S. registered investment companies. Mr. Conwill gave this advice as a matter of prudence rather than legality after becoming aware of the SEC's decision in the Insurance Securities, Inc. case.[34] In Mr. Conwill's opinion prudence dictated that Arthur Lipper Corporation not make charges on behalf of U.S. registered companies on over-the-counter transactions since Arthur Lipper Corporation might be charged with "interpositioning" (under the SEC theory

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34/ Securities Exchange Act Release 8226, (1968). The SEC there accepted an offer of settlement of a broker-dealer (not a member of the NYSE) which had been charging its affiliated registered investment company the NYSE commission rate on over-the-counter transactions. The staff had contended, in effect, that the broker-dealer had interpositioned itself between the broker-dealer firms selling securities to or purchasing securities from the registered investment company. [See 1934 Act Release No. 8226, page 6, particularly paragraph 15(c)]. The SEC agreed not to make findings whether or not the practices violated the Federal securities laws; it accepted the settlement on the condition that the broker-dealer "cease and desist, retroactively as of July 1, 1967, from charging any amounts in excess of the administrative cost of the services performed in connection with the purchases and sales of over-the-counter securities on behalf of" the registered investment company. (Id. at page 7)

that in the over-the-counter market the U.S. mutual fund manager can deal directly with the market makers and get the same price without incurring the extra cost of a commission). In addition, the SEC issued a release proposing to adopt Rule 10b-10, the effect of which was to require give-ups on behalf or at the direction of a U.S. registered investment company to go to the benefit of the U.S. registered investment company and its shareholders. Mr. Conwill advised Mr. Lipper that even though the NYSE might object because no charge was made, it might be better to have a fight with the NYSE rather than the SEC. (A 259-262)

On the other hand, with respect to foreign investment companies, Mr. Conwill told Mr. Lipper that Arthur Lipper Corporation was required to continue to charge the minimum NYSE standard commission on over-the-counter transactions, specifically mentioning transactions on behalf of the IOS related funds, and that Arthur Lipper Corporation could continue to share commissions with an NASD member. (A 260) While Mr. Conwill did not agree with the SEC's interpositioning theory, he nevertheless found it inapplicable with respect to the foreign investment companies because the terms of the IOS Settlement Order made it impossible for a manager of an IOS related fund to order directly a security, including an over-the-counter security, from the United States. Therefore, Arthur Lipper Corporation was performing an absolutely

essential service in effecting over-the-counter transactions for the foreign investment companies, was entitled to make a charge, and was not interpositioning itself even under the SEC guidelines. Finally, Mr. Conwill advised Mr. Lipper that if Arthur Lipper Corporation did not make a charge to the IOS related funds, Arthur Lipper Corporation would "have a real battle with the NYSE on that subject." (A 262-263)

Nothwithstanding the thoroughness of Mr. Conwill's advice, the SEC attacks it on the ground it was not disinterested because "...he was an FOF director and also counsel for IOS...." (SEC Br. p. 45) The SEC appears to suggest that Mr. Conwill was representing both IOS and Arthur Lipper Corporation when he gave advice concerning over-the-counter give-ups. This was simply not the case. Mr. Cowett made it quite clear that in the matter of commission sharing in the over-the counter market he was relying upon his own expertise; he stated he "preferred to take my own counsel."[35/] As for Mr. Conwill's role as a director

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35/ (Doc. 1, R 671) Mr. Cowett, a practicing attorney for sixteen years and an expert in the securities field who had co-authored a book on securities law with Louis Loss, was intimately familiar with the established practices of the industry and the views of the SEC with respect thereto (Doc. 1, R 461; A 136-138, 140-141). In Mr. Cowett's opinion "anybody with the slightest degree of sophistication in the securities market. . . accepted as a norm at that point that give-ups on regional and over-the-counter business to [NASD] members were completely acceptable and within the standards of what was permitted." (A 110-111, 134-135).

With respect to the possibility of sharing commissions with the IOS related funds, however, Mr. Cowett gave three reasons

of FOF, the SEC fails to recognize that as a director of FOF, Mr. Conwill had an obligation to make certain that FOF received best price and execution on portfolio transactions. Assuming arguendo that holding a directorship in FOF had any influence at all, its only effect, therefore, would be to motivate Mr. Conwill to seek the lowest rates possible.

A recent exhaustive law review article makes clear that Mr. Conwill's relationships with IOS were not the kind that vitiated his advice to Petitioners.[36/] The authors state:

35/ cont'd

why this was not done:

> In the first place, to this date I am not convinced that there is any legal way in which commissions could be retained--returned or paid over to a fund.
>
> Secondly: Within the context of the industry that we deal with, which is overseas in Europe, we are the exception, in that we don't charge extra commissions, and we would--we are, even today, treating the Fund more fairly than European funds generally do, because they end up taking extra commissions, and certainly in the arena and the mores of the place where we do business there would be absolutely no concept of giving back normal commissions that you may be able to benefit from.
>
> Thirdly: Forgetting the standards and mores of the industry in which we exist as opposed to the U.S. industry, and forgetting the legalities of any return or rebate that might be made, the third matter is that from the standpoint of pure profitability of IOS I would oppose the return. (A 139-140)

36/ Hawes & Sherrard, Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases, 62 Va. L. Rev. 1 (1976).

> Where counsel simply owns shares in the company or serves as a director or as an officer in it, his opportunity to gain personally from his advice beyond the benefits accruing to the corporation is so slight, if it exists at all, that no presumption of incompetence should arise. The courts have agreed, holding that these factors do not create the sort of conflict that will, as a matter of law, vitiate the competence of his advice to the corporation. (62 Va. L. Rev. 25; citations omitted).

Another significant point that should not be forgotten is the fact that all NYSE members who charged minimum NYSE rates on over-the-counter transactions and who shared commissions pursuant to customer instructions, including the twelve NYSE members described in this record, presumably did so on the advice of their own attorneys.[37/] The failure by the SEC staff to produce even one NYSE member, or his counsel, to support the SEC's position herein is truly demonstrative of the theoretical basis of its case.

B. THE AUTHORITIES CITED BY THE SEC DO NOT VITIATE COUNSEL'S ADVICE.

A convenient by-product of the SEC's failure to reach a timely decision in this case is the ability to cite cases decided in the intervening period, including uncontested cases before

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37/ Arthur Lipper Corporation's general counsel concurred in Mr. Conwill's advice. (Doc. 1,R 956). With respect to inside counsel, Hawes & Sherrard, supra, note 36 had this to say:

> Without a particularized showing that inside counsel has compromised his independent judgment, a presumption of disinterested competence should apply.... (62 Va. L. Rev. 26, citations omitted)

the SEC itself. For example, Provident Management Corp., 44 SEC 20 (1970), cited by the SEC at page 26 of its brief, was decided one year after proceedings were instituted by the SEC against Petitioners. In that case, which was uncontested, the SEC wrote an opinion that a violation of Rule 10b-5 occurred when an affiliated person of a mutual fund did not reduce its fees based upon reciprocal business which it received.38/

Delaware Management Company, Inc. 43 SEC 392 (1967), cited by the SEC at pages 29-30 of its brief, was, as the SEC admits, an interpositioning case. A broker, who had no execution capability but who distributed the shares of the mutual funds, was used despite the fact the mutual funds themselves (as the SEC noted 43 SEC 395):

> maintained a joint trading department consisting of two traders and other administrative personnel, and had direct telephone wires to various broker-dealers who were market makers or specialists in large blocks of securities. In some instances, the Funds in fact did trade in both listed and unlisted portfolio securities in the over-the-counter market directly with such broker-dealers. (citations omitted)

Here, the foreign investment companies were prevented by the

38/ The citation of Louis Loss' treatise, in which Professor Loss apparently rephrased the language of the Pollack letter, is similarly *ex post facto*. (SEC Br.p. 40) The note to that citation, 5, is the text of a speech by a mutual fund manager (who, unlike the foreign investment companies, could deal directly with the market makers), before a conference of state securities law administrators.

SEC from dealing directly with U.S. over-the-counter market makers.

The two cases which the SEC cites on the subject of disinterested counsel are factually distinguishable. Fogel v. Chestnutt, CCH Fed. Sec. L. Rep. ¶95,393 (2nd Cir. 1975), cited by the SEC at page 45 of its brief, involved "obviously casual" advice by an officer, director and 14% owner of the investment adviser to the investment company which failed to recapture portions of brokerage commissions which were allegedly available. The other case, Papilsky v. Berndt, CCH Fed. Sec. L. Rep. ¶95,627 (S.D.N.Y. 1976), cited by the SEC at page 47 of its brief, was another mutual fund recapture case. There (unlike this case) counsel represented both the investment adviser and the investment company; two regional stock exchange presidents testified that recapture would have been possible; and the opinion of the First Circuit in Moses v. Burgin 445 F. 2d 369 (1971) was ignored by the directors. The unique and complex situation presented to Mr. Conwill in this case was not present in the above recapture cases or any of the cases cited by the SEC. In none of the recapture cases was an unaffiliated broker-dealer named as a defendant or any way charged with a violation of "fiduciary" responsibilities as here.

Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, CCH Fed. Sec. L. Rep. ¶95,660 (2nd Cir. 1976), cited by the SEC at pages 48-49 of its brief, on the subject of good faith, was a

case where the defendant, an accounting firm, was held liable for its active participation in the preparation and issuance of false and materially misleading accounting reports upon which the plaintiff relied to his damage. The accounting firm, knowing that its audited report was required for a private placement conditioned on the report, nevertheless reported "income" from a real estate transaction which had not been consummated (property was contracted to be purchased at $13.2 million, with a $5,000 deposit, and to be sold for $15.3 million, with a $25,000 deposit, to a company with $100,000 in assets). The conduct of the accounting firm, however, is in no way comparable to the conduct of the Petitioners herein.

The cases cited by the SEC on the subject of jurisdiction are also factually distinguishable. Straub v. Vaisman and Company, Inc., CCH Fed. Sec. L. Rep. ¶95,623 (3rd Cir. 1976), cited by the SEC at pp. 59-60 of its brief, involved substantial participation by a broker-dealer in a scheme to sell securities of a company to which the broker-dealer was a financial consultant, and in which securities the broker-dealer was a market maker. The broker-dealer had inside information about the imminence of bankruptcy of the company and purchased the securities involved from a company which the president of the broker-dealer controlled. Needless to say none of these facts were revealed to the foreign purchaser of the securities.

C. THE EVIDENCE IS OVERWHELMING THAT PETITIONERS ACTED IN GOOD FAITH

The recent law review article cited supra, note 36 contains a distillation of the decisional law on the subject of reliance upon advice of counsel as follows:

> Generally speaking, reliance upon advice of counsel may serve as a defense to allegations of misconduct to which good faith or due care would be complete defenses, if the defendant in good faith and with care: (1) selected counsel he believed to be competent; (2) disclosed to counsel all facts which be believed to be relevant; (3) received erroneous advice on a matter of law; and (4) acted in accordance with such advice after it had been rendered.39/

In view of the decision of the Supreme Court in Ernst & Ernst v. Hochfelder, __ U.S. __ (1976), 44 L.W. 4451, that a person may not be accused of violating Rule 10b-5 "...unless he acted other than in good faith," the above factors are relevant to the conduct of the Petitioners herein.40/

39/ Hawes & Sherrard, supra, note 36 62 Va. L. Rev. 19, citations omitted. See 62 Va. L. Rev. 37-40 for the authors' suggested approach for applying the defense.

40/ Even though the Hawes & Sherrard article was written prior to the Ernst & Ernst decision, the authors concluded that good faith was the proper standard to be applied. 62 Va. L. Rev. 81, 126. Petitioners do not agree, of course, that the advice they received was erroneous.

With respect to securities cases in particular the article went on:

> On the other hand, the client's presumed inability to find and understand the law is a fundamental aspect of the reliance defense. On numerous issues, particularly in the securities field, the law is complex and often uncertain. Here the layman has no real choice but to rely on counsel. Courts, in upholding the defense under these circumstances have done so in the belief that a non-lawyer could not reasonably be expected to understand the applicable law. 41/

And with specific reference to SEC enforcement actions, the article said:

> In SEC enforcement actions, reliance on counsel may be relevant at two levels. The first concerns whether a defendant has committed a substantive violation; the second concerns whether the relief sought by the Commission is justified. This analytical distinction is crucial to an understanding of the role of the reliance defense. Yet, the courts and the Commission often seem to ignore it. 42/

41/ Hawes & Sherrard, *supra*, 62 Va. L. Rev. 36-37, citations omitted. The article further stated:

> The degree of complexity of the legal issue may be analyzed in terms of those offenses in which the layman's common sense and recognition of simple fairness could be a reliable guide, and those in which they could not. Certainly the layman's common sense would be of little help in resolving such complex legal issues as those concerning the availability of exemptions from registration requirements, the requirements of a tax-free reorganization, or the permissibility of including estimates in registration statements. Logically, at least, the more elusive the legal "answer" would be to a layman, the more weight a court should accord the evidence of his reliance. Where, in contrast, a court considers the legal advice relied upon to have been contrary to the plain language of the statute, or where it finds that the defendant's conduct defied common sense, it will usually find the advisee liable on the theory that the law was "clear" enough to negate any possibility of reasonable reliance on the contrary advice of counsel. (62 Va. L. Rev. 39, citations omitted)

42/ Id. at p. 80.

In this case, the SEC is focusing on the second level, as has been its practice. Petitioners, on the other hand, are focusing on the first level, where the SEC cannot claim it has a greater understanding than this Court of the decisional law with respect to Rule 10b-5.

When all evidence in this case is considered there can be no question that Petitioners acted in good faith consistent with each of the four factors described in the above law review article. At all times Petitioners relied on and consistently followed counsel's advice.

At the time this action was being tried, Mr. Lipper had spent approximately 16 years in the securities industry, 12 of those years servicing institutional clients, primarily mutual funds. (A 151). In 1958, he became aware that customer directed give-ups were prevalent in the mutual fund industry (A 164). 43/ Immediately prior to becoming President of Arthur Lipper Corporation in March 1967, Mr. Lipper was the partner in charge of institutional accounts at Zuckerman, Smith & Co., a member of the NYSE. (A 150). While Mr. Lipper was associated

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43/ In 1965 or 1966 Mr. Lipper requested his firm, Zuckerman, Smith, to ascertain whether the NYSE would permit charging no commission on over-the-counter transactions for institutions as a means of inducing listed business. Mr. Lipper was told that such an arrangement could not be done because the NYSE would consider it rebative.(A 228-229)

with Zuckerman, Smith customers directed that firm to share commissions on transactions on the NYSE and in the over-the-counter market. During this same period, the foreign investment companies instructed Zuckerman, Smith to share commissions on the NYSE and in the over-the-counter market. These instructions were followed with no distinction being made between give-ups on the transactions effected in the over-the-counter market and give-ups on NYSE transactions (A. 163-165)

When Mr. Lipper formed his firm in early 1967 it was his understanding at the time that NYSE members universally charged minimum NYSE rates in effecting over-the-counter agency transactions (A 168-169). Mr. Lipper's testimony in this regard was confirmed by every witness who testified on the subject. (See, e.g. A 33-34, 35-36, 144-145). Accordingly, based upon knowledge and experience, he had no reason to question Mr. Conwill's advice to charge minimum NYSE commissions on over-the-counter agency transactions and to honor customer give-up instructions.

Mr. Lipper took all reasonable steps to lower commissions charged to the foreign investment companies. He was keenly aware that the fixed commission rate structure of the NYSE was causing institutional customers, including foreign investment companies, to incur inflated charges. (A 212,214) Because of the large profits earned on all business originating from the IOS associated accounts, Mr. Lipper sought ways in which to provide more services to his customers since he felt he was unable to reduce his commission charges. (A 183-184)

The SEC's claim that Arthur Lipper Corporation could have satisfied the NYSE's cost test in 1967 and 1968, because it surrendered to IOS fifty percent of its over-the-counter commissions and "...would hardly have agreed to such payments had it meant that Lipper Corp. would be unable to cover the costs of its IOS business,"44/ is superficially appealing but inaccurate. This claim is founded on the incorrect assumption that Arthur Lipper Corporation's profits arose from the over-the-counter transactions, completely ignoring that Arthur Lipper Corporation earned much greater revenues on exchange transactions on behalf of IOS related accounts.

When Mr. Lipper and his counsel believed that the SEC would support the practice of not charging any commissions to U.S. registered investment companies, Arthur Lipper Corporation initiated that practice despite the fact the NYSE might object. Then, when the SEC finally forced the exchanges to ban give-ups, Mr. Lipper initiated the practice of charging customers, including IOS related funds, \$.06 per share on over-the-counter agency transactions. (A. 199-200)

It is ironic that the SEC should choose this bold action by Mr. Lipper, then unique for the industry in which he made his living, as evidence of his bad faith. (SEC Br. p. 37) It took courage for Arthur Lipper Corporation to "take on" the NYSE by itself as the only NYSE member charging less than the minimum NYSE rates on over-the-counter transactions. In fact, Arthur Lipper Corporation

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44/ SEC Br. p. 36.

wrote a letter to the SEC staff in 1969 (Doc. 16, R 1661-1665) seeking support for its practice of charging $.06 per share. The SEC staff did not provide even lukewarm encouragement. Indeed, it chose to ignore the letter; it did not even acknowledge receiving it.

When Arthur Lipper Corporation initiated the practice of charging $.06 per share on over-the-counter transactions, the NYSE immediately challenged whether the $.06 a share charge was sufficient to cover Arthur Lipper Corporation's costs and the NYSE withdrew its approval of an ad announcing Arthur Lipper Corporation's new policy of charging $.06 per share. Arthur Lipper Corporation submitted various studies to the NYSE in an effort to demonstrate that the $.06 charge was sufficient to cover its costs and the NYSE never accepted Arthur Lipper Corporation's position. (A 267-268)

Even if Mr. Lipper had been tempted to challenge the NYSE on the eve of Arthur Lipper Corporation's membership application, it would have been impossible for Arthur Lipper Corporation to have met the "cost test" referred to by Mr. Bishop in his testimony. Arthur Lipper Corporation could not have demonstrated as a practical matter what its costs of handling the proposed transactions would be because it had no history of operations. In addition, the start-up costs incurred by Arthur Lipper Corporation in establishing the extensive private communications link between Europe and the U.S. would have precluded Arthur Lipper Corporation from demonstrating that a charge less than the NYSE rate would have covered Arthur Lipper Corporation's costs. Obviously it would have been more

difficult for Arthur Lipper Corporation to demonstrate that it was covering its cost in executing over-the-counter transactions for the foreign investment companies than to demonstrate that it was covering costs on transactions handled for U.S. registered investment companies. Arthur Lipper Corporation was incurring large monthly expenditures in connection with maintaining its share of the communications network with IOS necessitated by the IOS Settlement Order, whereas this was not the case with respect to U.S. registered investment companies.

Realistically, Arthur Lipper Corporation was just not in a position in 1967, as a new applicant for membership in the NYSE, to initiate a frontal attack on the minimum commission rate structure, an attack that even the SEC was unwilling to make at that time. Subsequent events, including the institution of rate hearings by the SEC and the strong stand of the Department of Justice that the minimum rate structure is economically unsound, provided a more opportune climate in which such a challenge could be made; but in all fairness subsequent events should not be allowed to color the situation as it existed in 1967.

Notwithstanding the good faith exhibited by the Petitioners, the SEC chose to bar them from the securities business, ignoring their reliance on Mr. Conwill's advice. (A 439) The SEC's reasoning in refusing to consider counsel's advice in this case and in another case decided by the SEC was described as "Draconian" in the law review article cited above.[45] The authors there said:

45/ Hawes & Sherrard, *supra*, 62 Va. L. Rev. at p. 105.

Even recognizing that securities professionals have a special obligation to know the law relating to their business, the dictum in Brick and the cases cited in it is, we submit, Draconian. Instead of recognizing that under some circumstances reliance on advice of counsel could be relevant to a finding of lack of willfulness and then examining the particular reliance to see if it were adequate (as it was not in the cases cited), the Commission flatly asserts that reliance is irrelevant to that issue. Probably the result would be the same, but at least the principle would be maintained that strict liability is not the standard.

The Arthur Lipper Corporation proceeding adds one further dimension, namely that where counsel's opinion is not based on any precedent precisely on point and the clients were aware of the risk, "they can hardly claim that they could not reasonably forsee that the loophole which they perceived might prove to be illusory."

While again recognizing that the courts have upheld a different construction of the term "willfully" in the administrative proceeding context and have indeed sanctioned the view that willfully means merely that respondent intended to do the act, it is nevertheless difficult to accept the idea that strict liability is the standard and therefore under no circumstances would advice of counsel serve as other than a mitigating factor. Perhaps the Commission's answer is that such situations do not become proceedings. However, the breadth of the dicta applied in this area does not do credit to the Commission's adjudicatory function.

Oftentimes in SEC proceedings, where respondents have argued that they merely relied on counsel, the alleged violations were so extensive, the illegality so clear, that justifiable reliance was simply not a plausible defense. Typically, counsel, as it turned out, had not been fully or honestly informed of the facts.

* * *

In conclusion, then, when a broker-dealer has willfully violated a provision of the federal securities law, the SEC is authorized to take administrative action if it considers such action to be in the public interest. The Commission has generally refused to recognize reliance on counsel as relevant to the issue of willfulness, because of its policy that a respondent in an administrative proceeding should not be able to shift his duty of compliance onto counsel.

> Any other policy, the SEC contends, would be inconsistent with the public's justified expectation of being accorded the fullest protection of the law. Such a position is not, however, altogether fair or reasonable. Resort to legal advice on a very technical and complex question should at least be considered as evidence tending to negate a willfulness requirement. Where reliance was not in good faith or was unreasonable, it may be ignored. Or, where other circumstances seem to require the imposition of some sanction, reliance may simply be held a factor of insufficient consequence. In fact, in most of the proceedings in which the issue was raised, the reliance on counsel has clearly been improper for one reason or another. Nevertheless, the oftentimes categorical dicta espoused by the Commission are neither logically justifiable nor necessary to protect the public investor.46/

Applying the reasoning of the above article to the facts of this case, the good faith of Petitioners is more than apparent.47/ At all junctures Mr. Lipper relied on the advice and information given to him by Mr. Conwill, knowing that Mr. Conwill was a respected authority in his field and that other prominent NYSE firms, which were also presumably advised by competent counsel, were giving-up commissions pursuant to customer direction. (A 166-167, 189) Petitioners should not now be penalized for reasonably relying in good faith on the advice of eminent counsel, particularly when, in view of the widespread acceptance of give-up practices by the securities industry, only counsel could be expected to have the expertise required to determine whether give-ups under the circumstances were lawful.

46/ Id. at pp. 105, 106, 109, citations omitted.

47/ The SEC misreads the evidence with respect to industry practice in the case. Petitioners do not rely on industry practice to establish a claim of selective prosecution, as the SEC suggests (SEC Br. p.52) but to prove their good faith.

In the present case reliance on counsel is of critical importance because of the nature of the alleged violations. Unlike many of the broker-dealer cases involving, for example, violations of the net capital rule, this is not a situation where the law allegedly violated is clear. On the contrary, the complex jurisdictional questions raised by the IOS Settlement Order 48/ and the lack of case or statutory law as to the illegality of give-ups required reliance on counsel at all times.

IV THE SEC'S CLAIMS, THAT THE FOREIGN INVESTMENT COMPANIES DID NOT RECEIVE THE BEST PRICE AND EXECUTION, ARE UNFOUNDED AND CONTRARY TO THE EVIDENCE.

The SEC claims that the foreign investment companies did not receive the best price and execution (SEC Br. pp. 28-29) because the companies could have dealt with a non-NYSE member who charged lower commissions (SEC Br. pp. 19, 27-28, 38-39) or could have required that their transactions be executed on a principal basis (SEC Br. p. 17 n27). Neither of these alternatives was available. 49/

Under the IOS Settlement Order the foreign investment companies were precluded from directly placing orders in the United States; they were required to place all orders abroad through an independent foreign brokerage firm or through an independent U.S. brokerage firm with a foreign branch office.

48/ Witness for example the elaborate procedure worked out to permit the IOS enterprises to purchase and sell portfolio securities in the United States without violating the terms of the IOS Settlement Order (A 251-253)

49/ While we are obligated to answer these contentions made in the SEC brief, we point out that the SEC in its opinion (A 424-454) did not rely upon such contentions in reaching its conclusions. This is so even though the SEC staff had urged these positions upon the SEC in its quasi judicial capacity. Apparently the fact that arguments are advanced by the staff to the SEC and implicitly rejected does not prevent SEC counsel from trying them again on this Court.

However, as a rule, the only U.S. securities firms that had foreign branch offices were NYSE members. As a practical matter, then, the foreign investment companies could not place orders with a non-NYSE member (either on an agency or principal basis), unless they could convince the non-NYSE member to establish a foreign branch office and an elaborate communications network similar to that of Arthur Lipper Corporation.[50/] It is highly unlikely

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50/ Prior to December 5, 1968, the NYSE prohibited the use of a NYSE member's communications facilities for the placement of orders by a non-member unless the equivalent of a full NYSE commission was charged and the non-member bore part of the cost of the communications facilities. Even if the foreign investment companies were able to use Arthur Lipper Corporation's facilities to place orders with non-NYSE members, which they were not permitted to do under the IOS Settlement Order, they would not have saved any money but only increased their execution costs. Subsequent to December 5, 1968, the use of a NYSE member's facilities for the placement of orders was prohibited by the NYSE:

> (12) A customer of a member organization requests the member organization to transmit orders to buy and sell securities to a second member organization with which the customer has an account. The first member organization merely acts as a conduit, it does not execute or clear these transactions, nor does it receive any part of the commission charged by the second member organization. This will not be permitted. (A 459-471, 461)

In this regard, Mr. Conwill was advised by the NYSE that if the facilities of Arthur Lipper Corporation were used to place an order with another broker, Arthur Lipper Corporation would be required to charge the minimum NYSE standard commission rate on the transaction. The other broker would have charged the same commission and therefore the foreign investment companies would have incurred a double commission. If Arthur Lipper Corporation did not charge a commission, the NYSE would have considered the arrangement to be a rebative practice. (A 263-266)

that such an accommodating non-NYSE member could be found to undertake such an investment since the non-NYSE member would not have NYSE business to assure that the investment would be a profitable one.

Apart from the IOS Settlement Order, it was unlikely that a non-NYSE member would have had sufficient capital to execute orders for the foreign investment companies. By and large only NYSE members had the amount of capital to support the large volume transactions the companies typically generated.

With respect to the SEC's claim that a non-NYSE member "...could have effected more economical execution" (SEC Br. p. 39, n54) this is by no means as certain as the SEC suggests. While an institutional customer purchasing and selling securities in the over-the-counter market is naturally interested in the amount of the commission charge made by its agent, the most important consideration is the overall price the customer is going to pay or receive for the securities. For example, a customer would not object to paying a broker a minimum NYSE standard commission rate on an over-the-counter transactions where the institutional customer was able to acquire a large block of securities at a suitable price per share. On the other hand, the same customer would obviously not be satisfied if, instead of selecting a member of the NYSE, the customer placed a purchase order for execution with a nonmember broker who merely charged the customer the equivalent of one-eighth of the member's charge and, as a result of the nonmember's lack of expertise,

the overall price to the customer was larger. Mr. Cowett, who had broad experience in the institutional brokerage business, testified consistently with this obvious point. (A 117)

Accordingly, to sustain the SEC's conclusion that Arthur Lipper Corporation overcharged its customers, it was incumbent upon the SEC staff to introduce evidence and upon the SEC to determine that Arthur Lipper Corporation's customer's did not obtain best price and execution.

The SEC did not have before it any evidence, however, which would indicate that using another broker would have lowered the overall cost of executions for the foreign investment companies, much less that another broker would have been willing to cut its rates in the over-the-counter market. Give-ups from an aggregate of $2,666,000 in commissions on over-the-counter transactions are challenged. This volume of commissions means that they were obviously generated from literally hundreds if not thousands of transactions. Yet the SEC staff failed to point to a single instance where a more favorable price could have been obtained from someone other than Arthur Lipper Corporation. On the other hand, there is evidence that Arthur Lipper Corporation handled the execution of transactions in a most professional manner and was superior in this regard to many other brokers. (A 635; Doc. 1, 123, 392)

Similarly, the record contains no evidence that effecting transactions on a principal basis would have resulted in a better price and execution for the foreign investment companies.

Indeed, the SEC staff introduced not one shred of evidence to show that a better execution on a principal basis could have been obtained on a single transaction in which over-the-counter commissions were shared. On the other hand, the record does contain Mr. Lipper's explanation that his firm followed the policy of not executing on a principal basis because he wanted to avoid the conflicts of interest that arise when a broker acts as principal with his institutional customer. (A 222-223) Indeed, the Administrative Law Judge agreed with Petitioners and held that they were not required to effect transactions on a principal basis. (A 417) In addition as a practical matter, Arthur Lipper Corporation could not have acted as principal because it was hard pressed to maintain sufficient capital to comply with the NYSE net capital rule when transacting business on an agency basis. Arthur Lipper Corporation would have had insufficient capital for transacting business on a principal basis. 51/

V. THE RECORD DOES NOT SUPPORT THE SEC'S CLAIMS THAT DISCLOSURE TO DIRECTORS AND SHAREHOLDERS WAS INCOMPLETE AND MISLEADING

If the Court agrees with Petitioners that in the circumstances present in 1967 Arthur Lipper Corporation was not

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51/ Had Arthur Lipper Corporation adopted the policy of dealing with customers on a principal basis, it would have greatly increased its minimum capital requirements at a time when it had no excess capital, thereby restricting its ability to act for customers which had severely restricted access to the U.S. securities markets, contrary to the customers' best interests.

obligated to risk being charged by the NYSE with violating the most fundamental rule of the Exchange when it would have simply been unable to rebut such a charge, then no fraud occurred, i.e. no failure of disclosure to the board of directors of the foreign investment companies or the fund shareholders, since there was nothing to disclose.

Without conceding any duties of disclosure on their part, Petitioners do not agree with SEC's characterization of the record as demonstrating incomplete and misleading disclosure to the directors and shareholders of the foreign investment companies. (SEC Br. p. 19n 27; pp. 27-28) On the contrary, the record shows that extensive disclosure was made.

Brokerage practices involving reciprocal business and commission-sharing arrangements were first discussed by the board of directors of FOF at a meeting in Geneva in May, 1965. A very detailed discussion occurred at the meeting of the board of directors of FOF in late March of 1966. The meeting in March, 1966 immediately followed the order of the SEC which instituted broker-dealer proceedings against IOS. Because of certain facts recited in the order concerning give-up practices, this matter was extensively discussed at the March board meeting. (A 254-255)

Mr. Lipper attended certain meetings of the board of directors of FOF, including a meeting in March 1968 at Acapulco, Mexico. Mr. Conwill and Mr. Cowett also attended this meeting. At this meeting there was a full discussion of the procedure whereby Arthur Lipper Corporation shared commissions with IPC

on over-the-counter transactions. Mr. Cowett informed the board of FOF that it was the policy of IOS to benefit whereever possible from the use of commissions to the extent that it did not represent a detriment to the funds managed by the IOS affiliated companies. (A 180-181; 257-259)

Certain members of the board of directors of FOF were also directors of IIT and Regent Fund. Messrs. Cowett and Wyatt were members of the board of directors of Regent Fund. Mr. Harold Crang, a senior partner of J.H. Crang & Company, a primary broker for Regent Fund, was a member of the Regent board. (Doc. 144, p. 10, R 2263; A 132) Messrs. Cornfeld, Cowett Buhl, Roosevelt and Rinfret were members of the board of directors of IIT Management Company, the investment manager of IIT, a Luxembourg trust. (Doc. 142, Dx 44B, p. 6 Doc. 142, Dx 44c, pp. 5-6)

The board of directors of FOF was informed of the arrangements for commission-sharing between Arthur Lipper Corporation and IPC. There is no evidence that Arthur Lipper Corporation attempted to conceal the full details of the arrangement from the members of the Board. The burden of proof was on the SEC staff to establish that the IOS Respondents did not make full disclosure to the board members of FOF, IIT and Regent Fund. In addition, even if the SEC staff had met this burden, it would have the additional burden of demonstrating how an <u>unaffiliated</u> broker such as Arthur Lipper Corporation was required to make disclosure. The SEC staff failed to meet this

burden, nor did the SEC staff even attempt to meet its burden of presenting evidence from any member of the board, with the exception of Mr. Cowett.

VI. THE SEC STATED NO RATIONAL BASIS FOR SINGLING OUT PETITIONERS AMONG NYSE MEMBERS FOLLOWING INDUSTRY PRACTICE NOR DID IT JUSTIFY ITS DETERMINATION BARRING PETITIONERS FROM THE SECURITIES BUSINESS

The SEC attempts to justify its failure to institute disciplinary proceedings against other NYSE members who shared commissions on over-the-counter agency transactions pursuant to customer direction on the ground that the other NYSE members did not do so pursuant to a "scheme" or "plan" (SEC Br. p. 52). This distinction is tenuous at best since Petitioners did not share commissions pursuant to a scheme or plan either.[52] And it certainly makes no sense at all when read in conjunction with another ground which the SEC advanced to justify its harsh treatment of Petitioners:

> A determination that a person should not be permitted to remain in the securities business could well be legitimately predicated on conduct which was, in a particular case, less than intentional and knowing. (SEC Br. p. 51)

In the instant proceeding there was evidence of conduct of other broker-dealers, which, if at all, came closer to the definition of "scheme" or "plan" than the conduct of Petitioners.

52/ See I A & B, *supra*.

In Section VI of the SEC's opinion in this case (A 442) the SEC describes a blatant scheme, invented for the occasion and not following any industry practice, whereby customers' men of a certain broker-dealer would surreptitiously issue personal checks to IPC at the direction of their employers. Notwithstanding the type of conduct involved, the SEC was solicitous enough not to even mention the names of the two broker-dealers involved. However, because of the unusual nature of the conduct, it was a relatively easy matter to identify the two firms: Dishy, Easton & Co. and Hertz, Warner & Co. Both firms were, of course, disciplined by the SEC. But because both firms relied on the advice of counsel, the the nature of the violations found by the SEC and the sanctions which it imposed are helpful to highlight the arbitrary nature of the SEC's actions against the Petitioners herein. Violations of Sections 10(b) and 17(a) of the Securities Exchange Act of 1934 and Rules 10b-5 and 17a-3(a) thereunder, and Section 17(e)(1) of the Investment Company Act of 1940 were found solely for the purpose of those proceedings and without requiring the respondents to admit or deny the allegations in the orders for proceedings. The sanctions imposed: <u>fifteen day suspensions</u>, with the exception of Bernard Dishy, who was suspended for approximately two months, which suspension happily expired the same day a five month suspension imposed by the American Stock Exchange expired. Copies of both SEC opinions are included for the Court's perusal in the appendix to this reply brief.

The disciplinary action taken by the American Stock Exchange against Dishy, Easton exemplifies the attitude of the self-regulatory bodies. Under Dishy, Easton's arrangement with IPC, Fund of America, a U.S. mutual fund, would execute a NYSE transaction through Hertz, Warner, a member firm of the NYSE. Because IPC would authorize Dishy, Easton (who was a member of the American Exchange but not a member of the NYSE) to introduce NYSE business to Hertz, Warner, Dishy would share the NYSE commissions with IPC to the extent of 50% through the device of personal checks issued by registered representatives of Dishy, Easton. (Doc. 1, R 274) In return for business introduced to it, Hertz, Warner would use Dishy, Easton as a $2 floor broker on the American Exchange. (Doc. 1, R 276-286) The American Exchange complained that the give-up on NYSE business was a rebate of American Exchange business (Doc. 1, R 325) Thus, the American Exchange did not object to what was the equivalent of over-the-counter give-ups. Instead, the American Exchange took the position that what its member did in other markets was a rebate of American Exchange business.

CONCLUSION

The SEC staff, which had the burden of proof, failed even to introduce any evidence contradicting unequivocal testimony in the record showing:

1. The purported objects of the SEC's protection, namely, the foreign investment companies, were placed beyond the SEC's jurisdiction by its own order, i.e., the IOS Settlement Order;

2. The foreign investment companies were required by the IOS Settlement Order to use Petitioners' private communications system or its equivalent; they could not contact an over-the-counter market-maker directly;

3. Petitioner Arthur Lipper Corporation provided best executions for the foreign investment companies;

4. All other NYSE member firms charge the NYSE minimum commission for executing over-the-counter transactions on an agency basis;

5. Over-the-counter give-ups by NYSE members were a common, accepted industry practice at the time in question;

6. Like all other NYSE members, Petitioner Arthur Lipper Corporation charged minimum NYSE rates on over-the-counter agency transactions because the NYSE would not tolerate lesser charges without cost justification which Petitioners could not have provided. Evidence does not show a single instance of a member firm which sought to justify lower charges by "satisfactory" cost data;

7. The FOF Board, the outside members of which were uniformly distinguished and knowledgeable and some of whom were directors of the other foreign investment companies, were fully informed of the give-up arrangement.

8. Under customary European practice IOS would have been justified in charging the foreign investment companies an additional commission;

9. The Commission never used its ample rule making authority to outlaw such give-ups nor accepted the Special Study recommendation to adopt a statement of policy against them; and

10. There was no adjudication to the effect that such give-ups were wrongful.

11. Petitioners acted at all times on advice of a counsel extremely competent and knowledgeable.

For the reasons stated above and in Petitioners' Opening Brief, dated May 24, 1976, the decision below should be reversed and these proceedings dismissed.

Respectfully submitted,

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September 3, 1976

APPENDIX--DECISIONS OF THE SECURITIES AND EXCHANGE COMMISSION

(Securities Exchange Act Release No. 8874)

ADMINISTRATIVE PROCEEDING
FILE NO. 3-2155

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
April 29, 1970

In the Matter of HERTZ, WARNER & CO. 2 Broadway New York, New York (8-11687) IRVING HERTZ NORMAN CARNEY Securities Exchange Act of 1934 - Sections 15(b), 15A and 19(a)(3)	FINDINGS AND ORDER IMPOSING REMEDIAL SANCTIONS

In these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act") an offer of settlement was submitted by Hertz, Warner & Co. ("registrant"), a registered broker-dealer, and Irving Hertz and Norman Carney, partners of registrant.

Under the terms of the offer, respondents waived a hearing and post-hearing procedures, and, solely for the purpose of these proceedings and without admitting the allegations in the order for proceedings or that such allegations were applicable to all of them, consented to findings that registrant and Carney willfully aided and abetted violations of antifraud and record-keeping provisions of the Exchange Act and certain provisions of the Investment Company Act of 1940 and that Hertz and Carney failed to exercise reasonable supervision as alleged in the order. In addition, respondents consented to the entry of an order imposing certain sanctions upon them.

After due consideration of the offer of settlement, and upon the recommendation of its staff, the Commission determined to accept such offer.

On the basis of the order for proceedings, the offer of settlement, and certain materials accompanying the offer, it is found that between January 1966 and May 1968:

1. Registrant and Carney willfully aided and abetted violations of Sections 10(b) and 17(a) of the Exchange Act and Rules 10b-5 and 17a-3 thereunder in connection with the offer, purchase and sale of the portfolio securities of and shares in Associated Fund Trust and Fund of America, Inc., registered investment companies.

These respondents participated with other broker-dealer firms, which served as investment advisers and underwriter or distributor of the Funds, in activities which consisted of the obtaining and directing of brokerage business from the Funds that was secured by special inducements. Among other things, these respondents participated in certain reciprocal arrangements with those firms which provided for the allocation by those firms of the Funds' portfolio brokerage

(Securities Exchange Act Release No. 8702)

ADMINISTRATIVE PROCEEDING
FILE NO. 3-2155

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

September 23, 1969

In the Matter of DISHY, EASTON & CO. 40 Exchange Place New York, New York (8-11095) BERNARD DISHY Securities Exchange Act of 1934 - Sections 15(b), 15A and 19(a)(3)	FINDINGS AND ORDER IMPOSING REMEDIAL SANCTIONS

In these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act"), Dishy, Easton & Co. ("registrant"), a registered broker-dealer and a member of the American Stock Exchange, and Bernard Dishy, a partner of registrant, submitted an offer of settlement. Under the terms of the offer, respondents waived a hearing and post-hearing procedures, and, solely for the purposes of these proceedings and without admitting or denying the allegations in the order for proceedings, they consented to findings of willful violations as alleged in such order and Dishy consented to a finding of a failure of supervision. Respondents further consented to the imposition of certain sanctions.

After due consideration of the offer of settlement and upon the recommendation of its staff, the Commission determined to accept the offer.

On the basis of the offer of settlement and the allegations of the order for proceedings it is found that during the period from about January 1966 to about May 1968, respondents willfully violated and willfully aided and abetted violations of Sections 10(b) and 17(a) of the Exchange Act and Rules 10b-5 and 17a-3(a) thereunder, and Section 17(e)(1) of the Investment Company Act of 1940, and that Dishy failed reasonably to supervise persons under his supervision with a view to preventing such violations. During this period respondents participated in activities and transactions which consisted of the obtaining and directing of brokerage business from registered investment companies that was secured by special inducements. Among other things, respondents participated in certain undisclosed reciprocal arrangements with investment advisers of such investment companies which provided for the payment of direct and indirect pecuniary benefits to such advisers and others, in return for the allocation of portfolio brokerage transactions of the investment companies, and the receipt by respondents through such arrangements of direct and indirect benefits including brokerage commissions and give-ups. Such activities and transactions were not disclosed to the investment companies and their public stockholders, and registrant's ledgers respecting receipts and disbursements and income and expense accounts did not accurately reflect certain of these activities and transactions.1/

1/ See Consumer-Investor Planning Corporation, Securities Exchange Act Release No. 8542 (February 20, 1969).

CERTIFICATE OF SERVICE

I hereby certify, in accordance with the Federal Rules of Appellate Procedure, that I have served two copies of the Reply Brief of Petitioners Arthur Lipper Corporation and Arthur Lipper III on the Respondent Securities and Exchange Commission by causing said copies to be mailed this date to the following named person and address:

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Dated: September 3, 1976